II. INTRODUCTION

This report is commissioned by USAID's Office of Economic Growth, carried out by Deloitte Touche Tohmatsu, and "proposes options for G/EGAD/EM [sic] (now EGAT/EG) to consider as important roles and activities over the next ten years. These options will be positioned in the context of an overall framework (strategy) that identifies intervention type and regional focus in light of trends in financial markets globally as well as changes in the international financial architecture." This is the concluding paper of a series of four papers. The previous three were:

1. Review of International Financial Architecture

2. Role of Domestic and International Players in Financial Sector Reform

3. USAID's Recent Efforts To Improve Financial Markets' Efficiency

The strategy put forward in this report is based upon professional judgment and long-standing experience with the USAID organization, its programs, and with financial sector reform activities globally. It is not based on exhaustive evaluative data. While substantial information on inputs was available (i.e. project costs, contracting mechanisms, statements of work, etc.); very little information concerning outputs was available. The lack of significant project evaluations and the fact that we limited our work to Washington and conducted no field visits make it difficult for us to postulate the extent to which USAID has achieved development impact. Accordingly, rather than looking backward, the review is framed in such a way as to help EGAT/EG determine its roles and activities in the future.

The paper begins with a proposed framework or strategy for USAID's financial reform programming in Chapter I: Considerations for a Financial Sector Strategy. We reconfirm why financial sector reform is relevant to USAID's present and future mandate. Also, the first chapter discusses in detail two factors that are critical in determining USAID's financial sector strategy: 1) the areas of USAID's competence and comparative advantage in providing technical assistance, and 2) the diverse conditions of the countries in which USAID works. We describe how USAID might apply a structured methodology (termed a topology) to determine which particular reforms to pursue based upon the characteristics of countries it assists and current global trends. We go on to identify the types of assistance that would likely be appropriate for USAID to provide to countries in each of the categories.

In Chapter II, with these factors as background, we describe key developments in the structure of financial markets globally. Namely, the review identifies trends in the financial sector and their implications for the growth of domestic financial markets in USAID-assisted countries. These development issues are consolidated into five sets of trends for ease of understanding. In addition to these, there may be other trends not discussed in this paper, which we have determined to be either relatively less critical to developing countries or overshadowed by those discussed.

The influence of the change in the structure of international financial markets on USAID technical assistance programs is sufficiently important that we open Chapter II with an in-depth review of these trends[3]. In our first paper, Task 1 Report: Reform of the International Financial Architecture, we cite the efforts of international financial institutions (IFIs) and central banks to change the International Financial Architecture (IFA) to accommodate those trends. Because relevant policy decisions will be made in finance ministries and central banks, USAID staff are unlikely to have a role in designing IFA changes. We found, however, those institutions where financial sector activities are important, such as the World Bank, and those whose sole mandate is financial sector soundness and efficiency, such as the IMF and the US Treasury Department are providing more and more resources for surveillance. Yet, technical assistance needs are growing, due for the most part to the deficiencies discovered in these surveillance efforts. USAID assistance will be called upon to assist in implementing the needed reforms to fill the gap between existing and sound financial systems in developing countries.

To promote development, USAID-assisted countries must adjust their internal financial sector policies and institutions to adapt to the parallel trends of globalization, consolidation, and convergence among financial markets and intermediaries. Fortuitously, USAID efforts to change internal policies and institutions to accelerate development also contribute to financial stability. USAID's technical assistance to central bank regulators, and to the whole range of regulated financial institutions, generally entails training in prudential controls and stresses accounting transparency. Among their other virtues, these measures reduce the opportunities for the excesses that economists identify as the principal cause of international financial crises. We conclude that much of USAID's technical assistance promoting development has also supported resistance to the instability associated with integration of markets worldwide.

However, in concentrating on creating the elemental policies and institutions of competitive domestic financial markets, USAID has not yet substantially addressed some of the implications of the trends toward convergence and concentration among markets and institutions. One well-used example is that evidence now suggests that stock markets will not survive in small countries. So, we conclude that in contrast to USAID's past programs to assist each country create its own stock market, USAID's staff may in the future assist efforts to

[3] *It should also be noted that specific country situations are also a key factor in determining USAID programs. See section I.B.*

consolidate share trading systems into regional systems. There are likely to be other areas in which a regional or supranational approach might be more effective than a strictly national approach.

Chapter II goes on to describe four other sets of trends that will impact considerably USAID's future work: improved information disclosure and governance, e-finance, safety net reform (including pensions, insurance, and deposit insurance, among others) and new product development. The Chapter also sets out illustrative types of technical assistance that the Agency could pursue related to each major trend or issue area.

Chapter III proposes options for EGAT/EG's strategic involvement in financial sector development. What EGAT/EG can reasonably accomplish is directly related to the human resources and program funds it commands. Accordingly, we put forward a scenario analysis that takes into account varying levels of EGAT/EG's resources. We recommend that EGAT/EG management should match the strategic, central resources dedicated to the financial sector to USAID's future intended commitments in financial sector reform. This match should ensure that the technical areas of focus are pursued in a manner to achieve improved project selection and design and improved project implementation that will deliver accelerated economic development.

II.A. CONSIDERATIONS FOR A FINANCIAL SECTOR STRATEGY

II.A.1 Why Financial Sector Reform Is Critical to USAID's Mandate

It is widely agreed that financial sector reforms are among the key actions required to achieve dramatic reductions in poverty as well as sustainable economic growth. Therefore, financial sector reform is relevant to the work of all USAID staff who provide technical assistance, and see their work as primarily concerned with poverty reduction or general economic growth.

This is because financial markets are directly linked to people's use of, access to, and control over assets such as knowledge, technologies or infrastructure. The quality and quantity of workers' tools or assets determine the quality and quantity or their output. Financial markets, in turn, determine who can use existing assets and who can use greater and better assets. People's livelihoods - particularly those of the poor - largely depend on a strong financial sector.

USAID staff care about financial institutions and policies because improving them accelerates the creation of additional productive resources and facilitates getting those resources to the employers and self-employed workers who will put them to the most efficient uses. Improving the financial sector in a developing country accelerates growth in its stock of assets - buildings, technology, and management skills - and increases the efficient use of existing stocks of such resources by employers and by the self-employed. In turn, such improvements increase a nation's output, thereby contributing to poverty alleviation and economic growth.

It is well known that, since USAID's early days, dozens of countries have failed to begin building - or having begun, have failed to complete building - the financial institutions and policy systems that would move productive resources to their most efficient uses. Misguided and interventionist government policies as well as underdeveloped financial institutions have discouraged both foreign and domestic investment, thereby preventing creation of additional productive resources. In such environments, resources have been put to inefficient uses, often in government-owned businesses and private monopolies. As a result, workers have fewer tools than they might otherwise have, employers use tools and workers less efficiently, and production is less than it might otherwise be. Thus, people who may have had the opportunity to experience welfare improvements if provided with more tools applied more efficiently, remain poor.

Extensive, but incomplete, reforms that initially supported growth are also not sufficient in the long run. For example, in Thailand, Indonesia, and Korea, unreformed aspects of those countries' financial sectors brought economic instability that interrupted growth and plunged millions into unemployment and reduced circumstances in 1997 and 1998. Concerns about the repeat of such crises has sharpened the focus on developing countries' financial markets by IFIs, such as the World Bank and the International Monetary Fund (IMF); bilateral donors (e.g., USAID); and organizations such as the Bank for International Settlements (BIS), Organization for Economic Cooperation and Development (OECD), and the Financial Stability Forum (FSF).

USAID has funded technical assistance for financial sector reform in at least 761 cases at a cost over $1.2 billion during the period from 1988 to 2001[4]. The Agency is an important actor in the provision of technical assistance for financial sector development, undertaking about 50 projects per year and spending between $60 million and $100 millions annually. Compared to other donor agencies, USAID has been particularly important in the economic transitions of

[4] *See the third paper in this series, Batchelder, et al., Tasks 3 and 4 Report: USAID's Recent Efforts To Improve Financial Markets' Efficiency. The figures were produced for this project by Deloitte Touche Tohmatsu and were not directly provided by USAID. The dollar figures represent the contract amount obligated, based upon the 761 project statements of work analyzed by our team. They exclude any funds provided for on-lending (direct financial assistance) or guarantees. Our team did its best efforts to collect all relevant information, however, the quality and quantity of data available for each project varied widely. In the period of 1994 to 1996, these annual figures were at $100 million, the peak level of activity in the E&E region. Before and after those peak years, the average annual figure is $60 million. We believe the figures to be comprehensive, but do not guarantee their accuracy.*

the countries of Europe and Eurasia (E&E) and the Middle East, as well as in the areas of banking supervision, securities market development, and micro-finance.

The other donors and the IFIs have, over the same years, devoted more and more resources towards assisting policy reform and institution building in financial sectors[5]. Some host governments are becoming increasingly able to extend financial sector development without outside help. USAID's challenge is to identify those situations where needed reforms would not be made without U.S. assistance and where aid and host-government self-help will contribute to dramatic gains against poverty and suffering - a sort of triage approach to funds allocation.

USAID's development work has been and will continue to be done primarily through its Missions. At the same time, it is expected that EGAT/EG will continue to guide Mission and bureaus in selection, design, and implementation of high priority financial sector programs. The vision of current EGAT management is that EGAT/EG's overriding objective should be to support the Mission's core services of project selection and implementation, while providing technical leadership. In pursuing this objective, EGAT/EG faces a number of key challenges, such as:

- Which programs should EGAT/EG suggest the Missions select?
- It should also be noted that specific country situations are also a key factor in determining USAID programs. (See section I.B). What are the implications of the key issues in financial sector development for EGAT/EG?
- How will EGAT/EG support Missions and provide technical leadership that allows USAID to capitalize on its comparative advantages?

Many factors specific to, and independent of, financial sector development will affect these decisions. The answers to these questions cannot easily be deduced, because, above all else, the options for EGAT/EG are determined by the decentralized structure of USAID and budgetary considerations.

II.A.2. Factors that Influence USAID's Programs

USAID's evolving programs must take into account the changes in the structure of global financial markets. Within this context and as the provider of financial sector leadership for USAID, EGAT/EG should encourage a process that includes a rigorous analysis on a country-by-country basis that will indicate an appropriate USAID program for each country, based upon the following factors (some of which could be directly correlated):

[5] *See the second paper in this series, Garcia, et al., Task 2 Report: Review of Domestic and International Players in Financial Sector Reform. We estimate that the donors and IFIs spend approximately $700 million per year on financial sector reform.*

1. The USAID budget as compared to the size and type of technical assistance required;

2. What other donors are doing ;

3. USAID's ability to influence financial sector policy makers;

4. US foreign policy objectives;

5. USAID's current level of competence in the country and technical area (discussed below);

6. The political, economic, social and legal/regulatory characteristics of the country (which we also discuss further below) and the circumstances of the development of its financial sector.

Because of the relatively large array of possible interventions available to assist financial sector development in any one country, USAID's scarce resources must be allocated wisely to achieve optimum developmental impact. Consideration of different initial conditions in each country will help in determining not only how to proceed with reforms, but also how to sequence those reforms.

Those involved in implementing changes in the IFA, especially the World Bank and the IMF, are primarily concerned with maintaining financial stability and avoiding financial crises. As such, they advocate for the implementation of massive critical reforms simultaneously. Such an approach often requires several donors (or their contractors) to work on different pieces of the domestic financial market at the same time. Which "piece" USAID chooses to work on may be determined by what it has done before and how much money it has to offer.

Politics are another intervening, and sometimes confounding factor in developing a strategic approach to financial sector reform. In the United States, many Congressional policy makers believe that foreign aid should be considered part of the national security budget. USAID's involvements in post-conflict countries such as Kosovo or Afghanistan are examples of the implementation of that perspective. Such decision-making results in a situation in which a relatively small financial system, such as that of Kosovo, receives $53 million of US foreign assistance money for financial sector reform. Other countries or regions with needs that may be considerably larger remain neglected. The amount of financial sector development work being undertaken in Kosovo is large, and arguably disproportionate given its influence on global financial markets. USAID is the primary donor providing financial sector assistance in Kosovo. This situation meets the US political interests in the area, but not necessarily those of the international financial system. The economy of Kosovo has little impact on the stability of the US dollar or the euro and is not a large potential market for the US financial services industry. Nevertheless, political stability in the Balkans is linked to stability in Europe as a whole and therefore technical assistance in Kosovo has become a US priority. USAID's role in providing non-humanitarian assistance to foster economic growth is critical.

Given the considerable work this process entails, how do Missions obtain sufficient information to weigh these factors and make a determination regarding how and when to assist in financial sector development? We conclude that EGAT/EG has a pivotal and central role to play in providing this information to Missions.

USAID competence and country situations should be, in our opinion, the most important inputs to financial sector program development. Accordingly, we discuss them in greater detail. An understanding of USAID's level of competence or experience in the area requires that evaluations be conducted and that past scopes of work and resulting output be readily available. To understand country conditions, a financial sector assessment is probably required. Results of the Financial Sector Assessment Program (FSAP) overseen jointly by the Bank and the IMF are another important source of information. Below, we offer an additional suggested approach, in addition to an FSAP or structured assessment, which might yield the required information.

Areas of USAID's Competence In Providing Technical Assistance

As noted earlier, USAID's technical assistance helps governments take the multiple steps needed to implement lasting financial sector reform. Residence and consulting contracts permit Mission staff to respond as fast as or faster than other donors to requests for assistance. Despite the constraints of limited Congressional support for policy reform and a high level of earmarks, the numbers of financial sector reform activities identified in the course of this work (761) testify to USAID staff's success in mobilizing needed resources. As in the past, the USAID managers supporting financial sector development should continue to:

- Offer multi-year technical assistance as needed
- Deploy private sector skills quickly and in line with the requirements of specific projects
- Address special US foreign policy needs (e.g., Balkans, Afghanistan) as required

When assisting with financial sector reform, USAID's strength is the depth, breadth, and speed of response of the experts the Agency can field. On several occasions, USAID staff have stated that an area of USAID competence is working with the private sector[6]. While other donors, such as DfID and the EU, may also work with private sector groups, USAID's philosophy of market-directed financial sector development is an area of strength. These strengths have continued despite the organizational changes affecting USAID's Mission network and its technical capacity.

The Agency's once very extensive system of well-staffed Missions has been reduced by Mission closings and by reductions in the number of staff assigned to Missions. Perhaps more important, USAID's internal stable of economists, MBAs, and other private business sector professionals, has been substantially reduced by resignations and retirements[7]. Fortunately, Mission cutbacks and the attrition of technical resources have been offset in four ways:

1. SEED and FSA funding facilitated financial sector reform in the former Communist countries by providing funding for personal service contracts with technical professionals and the Financial Services Volunteer Corps (FSVC).
2. Mission, E&E Bureau, and EGAT/EG staff arranged cooperative agreements and contracts with private consulting firms that provided generally speedy access to a wide range of highly knowledgeable financial area professionals.
3. To preserve assistance quality in the absence of Mission technical expertise, some 37 percent of consulting contracts required the contractors to begin their work with an assessment of needs and means of appropriate assistance.
4. Staff have arranged inter-agency agreements with USG regulatory agencies to obtain short-term technical advice from experienced professionals on their staffs.

In their financial sector work under USAID contracts and agreements, MBAs, economists, bankers, regulators, and other experts have gained many additional years of hands-on experience with the character of deficiencies, the barriers to remediation, and the means to help officials in governments - or at least in sub-sectors of governments - who are committed to reform.

Experienced professionals are available to or are at present working for USAID offices to move reforms forward. The work of USAID-funded technical professionals assisting the banking sector is a notable example. The following table

[6] *Our work on Task 2 of this project does not provide the level of detail to support or deny this claim. However, it is noted by USAID staff as a strength and is, therefore, important to recognize.*

[7] *For example, during the 1990s, at least 29 economists (listed in Tasks 3 and 4 Report) left the Agency while none were hired. In 2002, about 9 financial sector specialists on personal services contracts were released from the E&E Bureau.*

provides some examples of the types of work that USAID has accomplished through its financial sector development work.

Furthermore, USAID contractors have often stayed or returned to oversee implementation of their recommendations and to assist with making the many parts work together. While these activities apply to banking and banking regulation, the professionals contracted by USAID have addressed the same range of activities in securities markets, housing finance, microfinance, other non-bank finance institutions, and, although to a lesser extent, insurance and pensions.

Table 3: Examples of USAID Activities in Financial Sector Reform

Banking	Regulatory Oversight
Privatization of state-owned banks	Introduction of draft legislation and passage into law
Introduction and passage of banking legislation	Provision of new and improved policies
Implementation of higher quality bank organization and management plans	Trained regulatory, auditing and management staff
Implementation of new personnel and management policies	Assistance with workouts or asset resolution in failing banks
Programs to educate the public about the availability and use of banking services	Development of deposit insurance schemes

Inter-agency agreements with United States government (USG) regulatory agencies have stemmed from recognition by Missions, contractors, and Washington offices that all financial institutions that serve the public must answer to regulatory institutions that impose rules intended to assure transparency, accountability, fairness, and that prevent corruption. Sometimes using former staff from the US regulators, many USAID contractors have been directed to assist in formulating legislation and organization plans for host governments' regulatory institutions. Eighteen percent of the USAID task orders surveyed have concentrated on market regulators, and 36 percent provided technical assistance to both regulatory institutions and regulated financial institutions.

This appreciation of the regulatory role, and this extensive experience with both levels of institutions, are special competencies that USAID can offer its client countries. Simultaneous attention to the two layers of operation is in fact desirable, and is a principle to which USAID staff have aspired to a greater degree than other assistance agencies with the positive result of greater consideration of private sector/market considerations in policy development.

After reading 761 task orders and interviewing dozens of USAID staff, contractors, and professionals from other government agencies, we have found three main weaknesses that might be cited: 1) excess creation of stock markets for small economies; 2) training bankers in numbers beyond absorption prospects; and 3) failure as yet to concentrate on support for enforcement systems that will assure the effectiveness of the many regulatory agencies USAID has assisted.

Allowing for the tendency of our interviewees to report that their work has gone well, we conclude that over the past dozen years, USAID's staff have generally been choosing financial sector projects sensibly and that the Agency's financial sector reforms appear to have contributed to both client country development and the Agency's policy goals. We further conclude that, in future, USAID offices should continue undertaking the kinds of institutional strengthening described above. Retrospective evaluations, focusing on lessons learned, could add considerable value to present and future work. Putting in place mechanisms for ongoing evaluation and exchange could also yield valuable information and contribute to improved programming.

Country Conditions

Adequate financial sector diagnostic studies are key to the ability of USAID staff to select projects knowledgeably. EGAT/EG should encourage general USAID use of the IMF/World Bank Financial Sector Assessment Program - by obtaining the publicly available outputs, the Financial Sector Appraisals (FSAs) and FSSAs (Financial Sector Stability Assessments). These provide thorough diagnostic tools that require no use of USAID resources. While highly desirable, USAID will likely not be involved in the formal FSAP efforts going forward. In lieu of such efforts, EGAT/EG should assist Missions to obtain the data that are produced as a result of the FSAP in each Mission's host country. Where FSAPs have not been completed or even undertaken, EGAT/EG should urge missions to consider obtaining an assessment, contracting for it if necessary, before arranging for any new financial sector initiatives - it is obviously important to understand and obtain agreement on what aspects of a country's financial system are 'broken' before making plans to fix them.

Topology: A Country Classification System

To assist in this process, we would propose that USAID, under EGAT/EG's leadership, consider developing a "topology", or country classification system, that can be used by Mission staff to develop a useful perspective on the position and performance of a country's financial system relative to that of other developing countries. This perspective would then drive the allocation of assistance efforts across subsectors of the financial system as well as the design of specific projects. While the FSAP process already provides useful information on the countries it covers, there are other, broader aspects that it does not cover - and these aspects are particularly important to consider in designing assistance programs.

For example, a national financial system that is highly vulnerable to crises - or one that is already in crisis - would likely need different types of assistance than one that is merely small or underdeveloped. Countries in the former category might be best served through urgent assistance in bank restructuring, establishing asset resolution mechanisms or improving surveillance; while countries in the latter category would benefit more from training and capacity-building activities carried out over a longer time period.

In a situation of high vulnerability or actual crisis, perhaps the most important determinant of types of assistance is the degree to which the country's government has demonstrated its commitment to financial sector reform. It is widely acknowledged that donor assistance works best in countries where the government is committed to reform; but this acknowledgement is not always reflected in practice. This is not to say that all financial sector assistance should be ceased in countries with laggard governments; on the contrary, the poor of such countries are typically in great need of donor help. Assistance in non-reforming countries, however, might best be limited to working directly with non-governmental organizations such as microfinance institutions, or providing training on transparency and governance directly to privately-owned commercial financial institutions.

Finally, the types of assistance that would be most effective for a country with a relatively small financial market are likely to be different than those for a country with a larger market. As alluded to earlier, establishing a national stock market would seem to make more sense in, say, Rumania or Bulgaria than it would in Montenegro. Small countries, like many in the Caribbean, that have few or no nationally-owned banks may not need a full-blown bank regulatory capacity - New Zealand provides an instructive example of this model.

Therefore, vulnerability, commitment to reform and market size might be three of the main criteria that USAID can use in developing a more rigorous country topology. Each is discussed below:

Vulnerability To Financial Crises: Developing countries' financial systems differ in the breadth, depth and nature of their vulnerabilities. The key vulnerability comes from the expectation of liability holders that they might not be repaid, which in turn depends on the perceived strength of banks and other intermediaries, as well as the extent to which liability holders, such as depositors, believe that their government can or will step in to protect their interests. This vulnerability is exacerbated to the extent that liability holders' doubts pertain to institutions holding a substantial percentage of financial sector assets.

One potential, albeit imperfect, measure of vulnerability is the quality of the system's assets as measured by the level of existing and expected non-performing assets (NPAs). Countries with high levels of NPAs need systemic reform to lessen the possibility of financial crisis. Countries with high levels of NPAs need not just bank recapitalizations that reduce NPA levels, but real sector restructuring to prevent recurrence of the problem in banks and to reduce the size of NPAs in other institutions. NPA levels, however, are somewhat of a lagging indicator of vulnerability and are specific to the banking sector. Other, more prescient and less subsector-specific measures should also be considered, such as perhaps foreign portfolio investment as a percent of total stock market capitalization.

Commitment to Reform: If a country is determined to be highly vulnerable to crises, it then makes sense to differentiate between countries committed to systemic reform and countries lacking commitment to reform. Admittedly, commitment to reform is difficult to measure in any quantitative fashion, but it should be possible to leverage Missions' experience and knowledge to develop fairly objective, if qualitative, indicators of this characteristic. At the time a financial sector strategy is being formulated, some vulnerable countries will be prepared to address their deep, systemic financial and real sector problems, while others simply will not. Such nations are rarely able to address longer-term development issues effectively when their short-term situation is problematic.

USAID should obviously avoid providing financial assistance to vulnerable countries that do not commit themselves to addressing the systemic problems that have caused their vulnerability. Missions may do best to hold support in finance at a minimum, consider assistance in other areas, and make it clear to the host government that USAID would support a serious reform program when the government demonstrates its commitment. Providing assistance through the mainstream financial institutions in these countries is likely to be counter-productive. Line-of-credit funds would likely be misused, that is, channeled to non-productive loans or loans that would not be repaid. Microfinance programs, however, may still be feasible and effective in these countries because these programs typically lie outside the financial core, utilize different intermediaries, and have staff not biased by crisis conditions.

USAID should likewise exercise great caution in providing technical assistance in such cases, because history shows that under such adverse conditions, reform activities are seldom successful and the support provided could well be wasted if target reforms are not implemented. TA could be provided to improve accounting and disclosure and provide honest rating services that could reveal the condition of the financial sector and its constituent firms. Learning about financial sector weaknesses might lead the press and the public to pressure authorities to embrace reform. Moreover, limited technical assistance to pro-poor NGOs offering micro- and SME finance independent of government interference might also still be promising in this context.

Market Size: Turning to countries that are not seen to be extraordinarily vulnerable to crisis, a primary distinction might be between countries with large and those with small financial sectors. Among "moderately vulnerable" countries, the large financial systems are quite diverse. It is feasible to support many activities in such systems, including capital market development, infrastructure or housing finance, pension reform, etc. While, we make several suggestions for project selection later in this report, there is no proven technique for identifying the best project in any given country. Attempting to do so would be misplaced. Rather USAID should continue to employ a pragmatic approach based in which project selection and design is determined by appraisals of past project results, USAID's staff capabilities and resources, host country priorities, US foreign policy imperatives, and the activities of other donors. Co-financing with other IFIs may be necessary for projects in large, diverse financial systems. Or, given the diversity of needs, USAID should choose projects within its staffing and funding capabilities. Still, it is useful to be mindful of what other donors are doing in order to avoid duplication and ensure strategic intervention.

A number of assistance programs that might be effective in larger countries are not likely to work well in countries with very small financial systems (60 countries have total financial assets of less than $1 billion). Studies show that countries with small financial systems benefit from importing financial services, particularly more sophisticated services, as their small size places them at a comparative disadvantage in producing financial services. Such countries may be best served by encouraging respectable foreign institutions to open branches in their country and having those branches supervised by the parent bank and its supervisor, rather than by building an independent financial system with domestic supervision. Alternatively, they could join other local small countries to provide regulation and supervision at a regional level as in CARICOM and CEGLA in the Western Hemisphere.

Overall we believe that size is an important consideration in financial development. The types of markets that are feasible depend upon volume of business. For example, only larger economies can support a securities market. Development of international e-finance, particularly in the securities market area, is likely to reduce further the viability of small markets - but at the same time, could make regional or global integration easier for small countries to achieve. In planning its country support programs, USAID should, in our opinion, consider the importance of scale and the comparative disadvantage of small countries in the domestic production of financial services.

Resource trade-offs may present an additional challenge to USAID Mission staff that are focused on one country. At a central level within USAID, priority should be given to countries that are vulnerable, but eager and willing to reform. Countries whose financial markets are in a weak condition require technical and financial assistance, but that assistance will only be useful in countries that have committed themselves to reform and have demonstrated the political will to make the often painful decisions needed to rescue or strengthen their financial systems.

The table below provides an illustration of one potential classification process:

Table 4: Potential Classification Process

	Condition of Financial Markets			
Characteristic	Highly Vulnerable (Systemic)		Moderately Vulnerable (not Systemic)	
	Willingness to Reform		Size and Complexity	
	Nonreforming	*Reforming*	*Small*	*Large*
Example	Nepal	Vietnam	Maldives	India, Thailand
Possible TA Types	• Microfinance • Disclosure and Governance	• Regulatory Reform • Asset Management	• E-Finance Access • Regionalism	• Pension Reform • New Financial Instrument

There are doubtlessly other criteria that can be useful in determining the most appropriate types of assistance for a given country, and the criteria we have proposed above are admittedly open to different interpretations. Moreover, once conceptual criteria have been identified and agreed upon, specific, measurable and objective indicators will need to be determined - developing a robust and useful topology is easier said than done. Our recommendation here is simply that USAID should consider developing a more standard, structured and objective approach to determine funding priorities among countries and selecting and designing projects within countries. The Office of Economic Growth would be particularly well placed to lead this effort, with substantial input from USAID Missions.

Once an initial topology has been developed, it can be tested and piloted in a number of countries and then revised as circumstances change. An election or other change in government can improve or decrease the authorities' commitment to reform, as has been seen in Asia and Latin America, for example. Natural or man-made disasters can increase a country's vulnerability. As the classification of the country changes, so will USAID's recommended options for TA and its country strategy. On an ongoing basis, EGAT/EG might take the responsibility to initiate the necessary rethinking and join with the USAID Mission in carrying out the assessment.

Eventually, a 'living' country topology that has been successfully field-tested and that yields reliable results might potentially form the basis of two other tools. First, USAID might develop separate topologies at the subsector level. A standard assessment mechanism could be designed, for example, to determine what type of assistance would be most useful in the pensions area or in commercial banking. Second, after sufficient experience has been accumulated, USAID/EGAT/EG might develop a "menu" of project types across and within subsectors, possibly with sample terms of reference that Missions can use as a basis from which to tailor country-specific projects.

Finally, while the specific needs and characteristics of each client country are and should of course remain the prime determinants of USAID's Mission-level assistance efforts, it is also important to ensure that these efforts help client countries integrate their financial sectors into the global economy. Doing so requires an understanding of the main global issues and trends affecting financial sector development - precisely the subject of the next section.

II.B. KEY GLOBAL TRENDS IN FINANCIAL SECTOR DEVELOPMENT

II.B.1 Introduction

As described above, country-specific development needs should remain the primary driver behind the selection and development of USAID financial sector assistance programs. However, programs should take into consideration and reflect global trends in financial sector development to the extent they are relevant to the country in which the program operates. If helping client countries to integrate themselves into the international financial architecture is an overriding concern of all USAID programs, then it is important that USAID staff understand the larger trends that are affecting the global financial landscape.

This section describes several key trends in global financial sector development that we believe are most relevant to USAID in designing and implementing assistance projects in client countries. The analysis is based on developments in the international financial architecture (Task 1), the activities of domestic and international players (Task 2), and our own observations of the way in which institutions and markets - in both mature and developing markets - have responded to forces shaping their financial systems. As mentioned in the Executive Summary, it was not our intention to make a rigorous or exhaustive categorization of all major trends or to predict the form and structure of financial institutions and markets in the future. Trends are by nature generalizations, and none will impact every USAID country in the same way or be relevant for markets still building basic two-tier banking systems. Nevertheless, global trends provide an important background to country-specific project design because they represent the likely future of international financial markets, and the overarching goal of most technical assistance projects is to help client countries prepare for a future in which they can compete successfully in a global marketplace.

After discussing what we believe to be the most salient trends affecting the global financial marketplace, we provide examples of how USAID assistance programs might respond most effectively to those trends, again subject to the primacy of country-specific considerations.

Important Trends

Over the last two decades, financial sectors globally have undergone a sea change. The key drivers of this change have been new technology, product innovation, opening of markets, and, ironically, financial crises. Technology has helped to reduce the costs of processing information and has empowered institutions to conduct transactions from around the world and created new platforms for trading almost every financial product imaginable. Product development has expanded the scope of intermediation from credit intermediation to risk intermediation. Broadened intermediation and the convergence of financial products have led banks into greater competition among themselves as well as with non-banks. Financial activities are harder to understand and increasingly take place outside of the traditional regulatory framework. There is a groundswell of debate around how public policies should be revised to reflect this evolution.

Moreover, the disruption to markets from financial crises - unprecedented in both frequency and scale over the last several years - have given rise to sweeping reforms to financial sectors. The US savings and loan crises provided a powerful reminder of the need to maintain skill and knowledge parity between regulators and the institutions they supervise, as well as the importance of early intervention. The Asian crises revealed the depth of interdependency among global financial markets and highlighted the importance of transparency and proportionality in regulation. The collapse of BCCI exposed significant weaknesses in the framework for regulating global institutions and the need for cooperation across borders. Crises in Mexico, Russia, Argentina, Central and Eastern Europe, and Turkey, as well as the scandals that beset Barings and Daiwa Securities, all hold their own lessons on the failure or inadequacy of traditional models of regulation.

The confluence of these developments in the global financial sector has triggered several important reform trends with implications for developing countries. We evaluated the relative influence of these key trends in the context of USAID's past work to identify which trends are likely to be most broadly applicable to USAID client countries over the coming decade. These trends are grouped into five headings, as shown in the box above.

5 Keys Trends Influencing Financial Sectors Internationally

1. Globalization, Consolidation, and Convergence of Intermediaries and Markets
2. Information Disclosure and Governance
3. E-Finance
4. Safety Net Reform
5. New Financial Products

Globalization, consolidation and convergence of intermediaries and markets are by-products of change in the industrial organization of financial services. As financial intermediaries face substantial competition in traditional lines of business, they are seeking new markets, reconfiguring their product/service portfolios, developing more efficient conglomerate structures, and exploiting regulatory imperfections by entering new businesses. These developments are combining to change the dynamics of the financial marketplace and have created new challenges in managing risk for regulators and institutions alike.

Information disclosure and governance have become the central focus of IFA reform, stemming from a need to increase market efficiency and reduce information asymmetry among intermediaries and issuers of securities. Three important elements of this movement are accounting reform, corporate governance, and facilitation of market discipline as an invisible hand of risk containment.

Electronic finance - electronic banking, electronic money and the provision of other financial services through electronic means - is spreading quickly, both in the developed and developing countries. This has significant implications for consumers, financial institutions, and supervisory authorities alike[8].

Safety net reforms are primarily centered on pension reform and financial assurances vis-à-vis deposit insurance and investor protection. While these areas are technically and administratively disparate, they both serve similar purposes for financial sector development. This is to harness long-term savings for productive investment and reduce the explicit and implicit cost of state funding for the sustenance/financial safety of consumers. Pension reform in transforming economies is further driven by the realities being faced in development economies from the rapid aging of the world's population.

New financial products and tools have done more to transform the character of financial markets than any other development observed over the last 20 years. They have created new sources of finance, induced disintermediation, enabled better management of risk, and increased the complexity of financial services, further burdening the already limited capacity of financial sector regulators in many developing countries.

These trends are admittedly broadly defined and not all will not be immediately relevant for every country in which USAID works. However, they are all applicable across a number of financial subsectors - banking, regulation, insurance, etc. - and all will in some way have tangible impact on USAID assistance projects in a majority of client countries.

[8] *Two reports worth reading are as follows: Group of Ten, Electronic Money: Consumer Protection, Law Enforcement, Supervisory And Cross-Border Issues, Basle, April 1997 and Basle Committee on Banking Supervision, Risk Management for Electronic Banking and Electronic Money Activities, Basle, March 1998.*